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ABSTRACT

Capital finance in institutions of higher education is analyzed in light of changes in the Tax Reform Act of 1986 affecting the ability of institutions to finance capital projects and the likelihood of changes in the government's view of tax-exempt financing. The options for colleges and universities are analyzed in the following areas: (1) conventional alternatives (proactive consideration of the term and security structure of debt, leasing as an alternative to traditional bond financing, understanding the taxable municipal market, credit support, private placements, credit market developments, technique developments, and following professional issues to anticipate problems and seize opportunities); (2) innovative alternatives (address your institution's credit standing; review new sources of state assistance; consider emerging corporate finance concepts; and selectively consider foreign-dominated debt or overseas issuances); and (3) ambitious alternatives (corporate spinoffs and forming systems). Developing an action plan is also discussed. (KM)

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# Rethinking Higher Education Capital Finance

by George A. King

The passage of the Tax Reform Act of 1986 (the "Act") understandably has dominated discussion among members of the higher education finance community. This attention is justified in some measure because the Act was considerably more than a legislative technical correction. The Act included significant, immediate and substantive changes affecting the ability to finance capital projects. Further, it very likely signals a new beginning with respect to the federal government's view of many tax-based economic and social incentives, including tax-exempt financing. This probable transformation is underscored by a symbolic gesture which should not be ignored: the amended and reorganized Internal Revenue Code of 1954 was renamed the Internal Revenue Code of 1986 (the "Code").

The absorption with tax law changes was necessary and has been useful. (See, for example, **Capital Ideas** Vol. 1, Nos. 3 & 4.) It is time, however, to review more carefully alternative approaches to higher education capital finance. The purpose of this article is to propose a framework for considering financing alternatives and to stretch the boundaries of what options are normally considered. This process of inquiry is as important in the office of the chief financial officer as it is in the laboratory and the classroom.

Colleges and universities operate with varying degrees of autonomy in their governance, management and financing. (Private institutions, of course, have more latitude than their public counterparts.) Many higher education institutions are communities of significant population and geographic size. Many also have annual cash flows, assets, liabilities, and net worth comparable to large corporations. It is fundamental when seeking to broaden the horizon of higher education capital financing alternatives to return to the local community analogy and the corporate business analogy for useful experience and examples of innovative successes. The non-profit, public service mission of colleges and universities, however, clearly will influence the adaptation of such innovations, as will the unique collegial decision making processes and institutional dependence on public appropriations and charitable support.

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### THE NEED FOR CAPITAL

As a general matter, institutions of higher education have certain identifiable needs for which financing is a critical element. (See Harvey Kaiser, "Capital Needs in Higher Education," in **Financing Higher Education: Strategies after Tax Reform.**) Most of these needs for capital can be categorized broadly in the following manner:

- Financing of direct revenue-producing facilities (e.g. dormitories and dining halls).
- Financing of indirect revenue-producing facilities (e.g. laboratories for research with potential commercial applications; athletic centers from a general student fee; and upgrades to telephone and communication systems which, at least in part, increase efficiency).
- Financing non-revenue-producing facilities (e.g. land improvements and administrative buildings).
- Short-term capital financing in anticipation of long-term financing for any of the above.
- Equipment financing.
- Short-term cash flow financing.
- Financing special programs (e.g. loan funds and student aid).

The higher education finance community can take a more proactive approach to meeting these financial needs. As a general matter, there are few structural impediments to such an expanded approach. This assertion notwithstanding, college and university officials must proceed cautiously, taking into account not only procedural and administrative issues but also political and reputational concerns.

## A FRAMEWORK OF OPTIONS

As an aid to the consideration of alternative financing responses to the need for capital, the range of potential choices can be classified as: conventional alternatives, innovative alternatives and ambitious alternatives. Most of the financing options that college officials can reasonably adopt will be in the first category, conventional alternatives. It is important, however, that financial administrators consider the other categories and perhaps have an occasional report prepared on the more far-reaching responses to the need for capital. While the probability of implementing an innovative or ambitious alternative is lower, the potential gain can justify a disciplined cost-benefit analysis. The working definitions of these terms are given below:

**Conventional Alternatives** are defined as those responses which may not have been historically emphasized by colleges, but which, in whole or in part, are currently in use and/or are accepted alternatives for the higher education financial community. The primary barrier to their use is unfamiliarity with technical and operational details of implementation.

**Innovative Alternatives** are defined as responses which require institutions to break new ground and to operate in areas where substantially applicable precedent by other higher education institutions may not exist, but which for individual reasons may have merit.

**Ambitious Alternatives** are defined as long-term responses which have implications beyond the scope of any particular financing. These responses may require the dedication of considerable resources and may impact non-financial activities of an institution in a major way. These actions also may require the cooperation of other organizations outside the usual sphere of the institution.

Again, this classification should not be considered a hierarchical ranking of desirability. A conventional response is likely to be more appropriate than an innovative or ambitious response. However, it is important to under-

stand the alternatives that you choose not to utilize as well as those which you choose to embrace.

## CONVENTIONAL ALTERNATIVES

Certain choices are available to the financing team at colleges and universities which, in whole or in part, have been utilized by other institutions and have been found to be practical and beneficial. Sometimes the only barrier to their adoption is unawareness of their existence. More commonly, financial officers may know of an alternative but not have familiarity with the technical aspects of implementation. This lack of familiarity should not be a serious matter as the necessary expertise can be developed internally by training existing staff or hiring additional personnel. Expertise may also be accessed externally from a financial or law firm. Examples of conventional alternatives include:

**Proactive Consideration of the Term and Security Structure of Debt.** The menu of alternatives in the area of short-term, medium-term and long-term debt and in the type of security available to be pledged offers college financial officers flexibility in crafting financings which are individualized to their institutions' needs and strengths. The availability of variable rate financing options, including multi-modal structures (wherein a constant selection among rolling term and interest rate alternatives is possible) means that the selection of a particular financing structure should not be an automatic response. Each institution should exercise the power of choice which the highly diverse market for debt instruments currently offers.

Similarly, the variety of security structures which are accepted in the current debt markets has greatly increased the opportunity cost of not considering alternatives. For example, if your institution is not familiar with the variations among general obligation securities, various revenue-based bonds and notes, certificates of participation and other methods of lease financing, and the various types of liens and pledges which can be used in conjunction with real estate, then your institution is not considering alternatives which are currently in general use today by colleges and universities. In certain cases, there may be legal issues which need to be resolved. Your state's applicable educational facilities authority, for example, may not have the corporate power to implement certain tax-exempt structures. These matters can usually be favorably resolved either upon initial analysis or with appropriate amendments to applicable legislation or institutional charters or bylaws. In addition, the existence of covenants and restrictions in connection with prior financings can usually be addressed successfully through refundings, defeasances, restructurings, redemptions, the development of special-security credits, the selective use of subordinate credits with accompanying senior lien financing restrictions, and other techniques.

In sum, the current debt market is sufficiently large, diverse and sophisticated to afford an outlet for a wide spectrum of financing structures. Educational facilities authorities and the institutions which enter the debt markets directly can derive substantial benefits by constantly maintaining their awareness of the available alternatives.

**Leasing as an Alternative to Traditional Bond Financing.** Although the tax-exempt bond market remains the cornerstone financing tool for most colleges and universities, this type of bond financing cannot, for a variety of reasons, satisfy all needs. Tax-exempt lease debt is an alternative to bond financing which may warrant further investigation by many educational institutions. Such leases have become increasingly common in recent years. Standard & Poor's, for example, rated over

**The current debt market is sufficiently large, diverse and sophisticated to afford an outlet for a wide spectrum of financing structures.**

The June 1987 issue of **Capital Ideas**, entitled "New Approaches to Debt Financing," provides an overview of many tax-exempt debt instruments. A more detailed resource for examination of the tax-exempt market can be found in several applicable chapters of **Financing Higher Education: Strategies After Tax Reform**, a compilation of papers presented at the Forum's 1986 symposium and published by Jossey-Bass. Papers from the 1987 symposium will be published by Macmillan in early 1989 under the title, **Financing Higher Education in a Global Economy.**

**Lease financing may be able to mitigate the effects of certain public finance restrictions such as debt limits, expensive and lengthy voter approval processes, and state legislative resistance to long-term funding commitments.**

**A relatively recent innovation is a taxable issue that can convert to tax-exempt debt upon the satisfaction of certain conditions or upon the occurrence of certain events. These exchangeable bonds can used to maintain an institution's tax-exempt debt level at the $150 million maximum.**

$2.7 billion of lease debt in 1987.

Tax-exempt leases can be used for an array of projects, including equipment, furnishings and buildings. Lease debt has several hybrid legal characteristics which make it a versatile tool when used for suitable purposes and a proportional segment of an institution's financing plan. Lease debt receives the beneficial treatment of being categorized in the same manner as bonds when bond counsel delivers its opinion as to the tax-exempt nature of interest payments. However, lease financing falls outside the definition of debt under the statutes and case law of many jurisdictions. As a consequence, lease financing may be able to mitigate the effects of certain public finance restrictions such as debt limits, expensive and lengthy voter approval processes, and state legislative resistance to long-term funding commitments. Lease debt has been widely used in many states, most visibly in California, and the rating agencies are familiar with many variations.

**Develop an Understanding of the Taxable Municipal Market.** In the wake of the recent federal legislative assault on the tax-exempt debt market, substantial attention has been given to the taxable debt markets. In particular, the application of the state volume cap concept, the $150 million institutional limit applied to private colleges and universities, the more restrictive approach to "private use" standards, and the specific removal of certain project categories from the tax-exempt domain have stimulated broad interest by many public finance market participants in taxable alternatives. Most discussion in the higher education community to date has focused on the $150 million dollar institutional limit. A reason may be that large private universities, the prime quarry for this restriction, have both the need and the sophistication to enter the taxable market. But private institutions that might never approach the $150 million cap or public universities that are not subject to it may also need to consider the taxable market for projects which will exceed "private use" standards.

A relatively recent innovation is a taxable issue that can convert to tax-exempt debt upon the satisfaction of certain conditions or upon the occurrence of certain events. For example, in June 1988 Georgetown University found the interest rate environment attractive but temporarily lacked access to the tax exempt market due to local political factors. By issuing exchangeable bonds, Georgetown University locked in interest rates for both taxable and tax-exempt modes.

Exchangeable bonds can also be used to maintain an institution's tax-exempt debt level at the $150 million maximum by continually issuing all debt over the allowable limit as exchangeable debt. When a portion of prior debt matures, a corresponding amount of exchangeable debt can be converted to a tax-exempt basis to fully utilize the institution's $150 million cap. In the context of the ever-changing federal tax landscape, exchangeable debt holds substantial possibilities and illustrates the need to monitor financing innovations.

**The Credit Support Approach.** The role of credit support in the higher education credit markets is well established and includes municipal bond insurance products, direct pay and standby letters of credit offered by domestic and foreign banks, and a variety of guarantees. In spite of the general awareness of the basic forms of credit support, higher education financial officers must keep informed of new developments. For example, recent federal legislation established the College Construction Loan Insurance Association ("Connie Lee") to provide credit support for colleges that did not have adequate access to the credit markets. Through its wholly owned subsidiary, Connie Lee Insurance, the newly established firm will provide bond insurance and reinsurance for the construction, purchase, lease, and modernization of higher education facilities and equipment.

Another innovation which has emerged from the credit enhancement segment of the market is the substitution of a credit instrument, such as a line or letter of credit, for cash when funding reserve funds. The competitive pricing of credit enhancement instruments has made this structure attractive and, as a second benefit, private institutions have used this technique to preserve the full $150 million of tax-exempt debt available to them for project purposes.

**Private Placements.** Private placement financing is almost too broad a term to be applied to the financing needs of any higher education institution. There are technical legal

parameters for a true "private placement" and they must be observed scrupulously (e.g. a limit on the number of and the financial sophistication of the persons to whom the private placement may be offered). For the purposes of this discussion, private placements are considered to be those financings which are not the subject of an offering to the public. These are typically the province of institutional investors, but recent legal developments in the field have expanded the types of eligible investors.

An advantage of a private placement financing is that it offers a viable outlet for innovative or complex legal and financial structures. Purchasers in this market are sophisticated and, in many cases, will not be inhibited by the hesitancy of a rating agency to embrace a financing approach. Consequently, a college or university may be able to implement a complex financing structure that would be prohibitively expensive in the public market.

The private placement market is also significant because it provides a point of access to the venture capital market. Many of the institutions and individuals engaged in the private placement market are also active in venture capital efforts to commercialize technology.

**Capitalize on Credit Market Developments.** From time to time, the degree of competition is raised to a higher level, either on a permanent or temporary basis. New products are constantly being introduced and market participants are continually adjusting their commitment to the higher education finance industry. In addition, forces of competition and realignment are sometimes applicable to entire segments of the financial markets, providing a window of opportunity. For example, in recent years Japanese financial institutions have offered their products and services at very competitive pricing levels. Other market participants have emphasized their own strengths, thereby offering university financial officers a wide variety of pricing and service combinations from which to choose.

**Monitor Technique Developments.** Several of the most exciting innovations in the higher education finance market have come about as the result of finding new techniques to accomplish what are essentially standard financing objectives. An excellent example of this is the municipal swap market. Conceptually, interest rate swaps are simple enough as they represent an exchange of payment obligations between two parties. (Typically debtors with variable and fixed rate obligations respectively are parties to the transaction.) In spite of the conceptual simplicity, the innovative possibilities are tremendous. When tax analysis related to tax-exempt income and the constitutional and statutory analysis related to educational facilities authority powers is considered, swaps can become very complex. Under many circumstances, however, swaps can be tailored to be a cost-beneficial alternative to refinancing or can be used effectively in conjunction with new issues.

**Follow Applicable Professional Issues to Anticipate Problems and Seize Opportunities.** Developments in professional areas, particularly in the legal and accounting fields, can have a profound impact on the financing programs of colleges and universities. Institutions which are organized as 501(c)(3) entities are affected more frequently than state organizations, but all colleges and universities need to monitor and manage professional developments. Developing legal issues affecting higher education finance are frequently found in the area of tax law. For example, a recent IRS Private Letter Ruling related to the financing project of a YMCA held that YMCAs in various cities are sufficiently distinct that they should not be consolidated for the purposes of the $150 million tax-exempt financing institutional volume cap. In addition, another recent IRS Private Letter Ruling, on the question of the relationship between university debt and that of an affiliated hospital, concluded that the hospital's financing should not be counted against the university's tax-exempt debt cap. (Rulings only provide guidance and cannot be used as legal precedent.) These are just two examples of many new legal developments that continue to affect higher education finance.

In addition, official IRS regulations are often significantly delayed in publication after laws are enacted. Informal networks may be very helpful in assisting institutions in anticipating upcoming interpretations. During this period, the financing team frequently develops functional parameters of acceptable financing techniques which are responsive to the new law,

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often in informal consultation with Treasury Department officials. In certain cases, issuers may file a request for a private letter ruling before proceeding with a financing. Many of the conventions in the area of arbitrage and rebate, particularly as applied to unusual variable rate financing techniques and refunding techniques, have been developed in this manner due to the interest rate urgency in bringing the issues to market.

The realm of accounting developments is another professional area in which changes in convention and regulation have a profound impact on higher education institutions. One of the most high-profile issues affecting the financial status of higher education institutions is the

## USING CASH

Some colleges and universities prefer to pay for capital improvements with cash — either reserve funds that they hold or funds donated by benefactors. The Directors of the Forum believe that this "conservative" approach has a good deal of merit in this era of high real interest rates and, in the for-profit sector, at least, the almost unbounded speculative acquisition of real property with debt financing. This caution notwithstanding, cash financing may be an inefficient use of funds for colleges and universities with access to the tax-exempt markets and good credit ratings. The reason for this inefficiency is that the cost of borrowing in the tax-exempt market may be lower than the investment return that these funds could earn in the taxable market. In effect, there is a "natural arbitrage" opportunity. Moreover, the investments and the debt can be structured in a complementary fashion to essentially eliminate risk. It is critical, however, to consult with tax counsel familiar with tax-exempt finance well in advance of planned financing in order to structure the relationship among institutional reserve funds, outside donations and tax-exempt financing proceeds within the laws and regulations of the Code. An institution may not, for example, specifically raise funds for a building and then issue tax-exempt debt for the same purpose.

**"Cash financing" may be an inefficient use of funds [because] the cost of borrowing in the tax-exempt market may be lower than the investment return that these funds could earn in the taxable market...An institution may not, however, specifically raise funds for a building and then issue tax-exempt debt for the same purpose.**

If an institution must enter the *taxable* market for funds, this "natural arbitrage" is likely to evaporate or turn negative. In such cases, cash may be the preferred mode of financing. However, many higher education institutions will not have sufficient cash available. Consequently, institutions should begin planning now if it seems likely that they will need cash to finance capital projects in the future. One way to do this is to develop a realistic depreciation schedule and fund it. (The proposed FASB and GASB rules only affect reporting depreciation rather than funding it.)

Another alternative to actually going to market with a taxable issue is to carefully coordinate taxable debt needs and investment management. Most endowments and public college foundations maintain a balanced portfolio, one with both equities and fixed income securities. Furthermore, portfolio managers are often instructed to maintain a minimum percentage of their investments in fixed income securities. The first segment of debt held by endowments or university foundations should be the institution's own taxable debt issues or the equivalent in interfund borrowings. If the plant fund borrows from the endowment fund at the same rate it would pay if it went to market, the endowment fund can earn a market rate of return with no third party credit risk. In addition, the plant fund will save the costs of issuance. It is more complicated to use these techniques when raising funds for research facilities. If a facility will ultimately be supported by overhead payments on grants and contracts, the institution may actually want to issue the debt because imputed interest on interfund borrowings is not an "allowable" cost for purposes of determining overhead.

**The first segment of debt held by endowments or university foundations should be the institution's own taxable debt issues or the equivalent in interfund borrowings.**

Richard E. Anderson
Forum Director

debate over depreciation. It is not possible to make an informed financial decision at a higher education institution today without taking into consideration the accounting treatment of that decision.

### INNOVATIVE ALTERNATIVES

Certain financing alternatives which are available to higher education institutions require college financial officers to break new ground and to operate in areas where substantially applicable precedent activities by other institutions of higher education may not exist. While the effort required by innovative responses may be great, the advantages can be equally significant. Examples of innovative responses include:

**Address Your Institution's Credit Standing.** The credit ratings carried by a college or university are very significant. Ratings represent market access and the cost of that access. While lower credit ratings are not always a bar to issuing debt, they raise the interest rate and cost of the issue. Therefore, an improved credit rating carries meaningful economic benefits.

The determination of credit ratings is both a science and an art. The major rating agencies, Moody's Investors Service and Standard & Poor's Corporation, emphasize slightly different criteria. The underlying fundamentals of college and university operations which these agencies consider are constantly changing. Therefore, the potential for a credit rating upgrade and the risk of a downgrade should be considered on a regular basis. For example, consider the evolving nature of the following partial list of rating agency criteria: (i) level and growth of endowment; (ii) fundraising performance; (iii) demand for the institution's programs as evidenced by the number and quality of applicants and the level of funded research; (iv) prominence of the institution; (v) dependence on state and federal programs and the stability of those programs; (vi) existing debt burden and debt service coverage; (vii) level of financial cushion; and (viii) institutional leadership.

College financial officers can work directly with investment bankers and financial advisors to change both the perception and reality of the measures listed above. A financing team can launch a campaign to make certain that the rating agencies have correct and appropriate information. They may, for example, try to persuade the rating agencies that the quality of applicants should be measured differently for the client institution. Or, the financing team can make certain decisions which will reduce the existing debt burden or raise the level of financial cushion. Universities as diverse as Cincinnati, Clemson, Columbia, Hartford, Indiana, and Purdue have achieved rating upgrades in 1988.

**Review New Sources of State Assistance.** For a publicly supported institution, the predominant source of funding is its state appropriation. In many cases, the appropriations cannot be directly pledged as security for debt. Consequently, it is often the state that issues bonds, typically general obligation bonds, when capital financing is required for a public college or university in its jurisdiction.

It is common that existing appropriation financing and debt financing mechanisms predate the development and market acceptance of more recent financing alternatives. As a result, there may be an opportunity to change state assistance mechanisms and increase

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**The concept of a dual credit approach has been proposed in New Jersey, where a large higher education finance program is to be accomplished using a combination of state general obligation bonds and college revenue bonds.**

### New Reports

**Two new reports on debt capacity and credit ratings have become available within the last two weeks. J.P. Morgan Securities, Inc. has issued "Capital Financing for Higher Education." The booklet reviews selected higher education trends and considers capital needs. There is also a brief review of legal issues and a more thorough review of ratio analysis for both public and private institutions.**

**Standard & Poor's has just issued a similar report, "Higher Education Credit Review," which discusses the factors affecting credit ratings. It also reviews 22 specific credit rating decisions. Taken together, these two publications provide a wealth of information for college and university capital planning.**

**Both reports are available through the Forum without charge. Write Barry Sugarman, Box 38, Teachers College Columbia University, New York, NY 10027.**

**If real interest rates remain high, bonds indexed to inflation may be less costly to the issuer than more standard variable rate debt.**

available financing or reduce the cost of financing. Obviously, this is not a short-term endeavor and is likely to require considerable political and analytical background work.

At least one state pledges lottery receipts to secure capital financing, although not specifically for higher education purposes. These lottery receipts can serve as the sole security or in conjunction with other revenue sources. The concept of a dual credit approach has been proposed in New Jersey, where a large higher education finance program is to be accomplished using a combination of state general obligation bonds and college revenue bonds (certain revenues are now under institutional control as a result of autonomy legislation). California has been fertile ground for the development of several special district financing concepts. The rating agencies are familiar with many of these hybrid credit structures and in several cases the issue has received a higher credit rating than prior financings.

The most important considerations in examining these and other new hybrid credit approaches are to be flexible in drawing features from various sources and to address the specific economic and political needs of your institution's environment. While the challenge of each innovation is significant, so are the potential benefits.

**Consider Emerging Corporate Finance Concepts.** The first part of this review urged financial officers to consider a variety of debt financing techniques that have been used, in whole or in part, by other colleges and universities. Consideration should not, of course, be limited only to new *higher education* finance techniques nor to *tax-exempt* techniques. The realm of corporate finance also should be surveyed.

An example of an interesting new approach is that taken by the Franklin Savings Association which issued "Real Yield Securities" or "REALS" in early 1988. While many variable rate securities are indexed to Treasury rates or LIBOR, the yield on REALS is indexed to the Consumer Price Index for All Urban Consumers. This obviously has certain attractive features to investors who want to be sure that their investment keeps pace with inflation. Moreover, if real interest rates remain high, then REALS may be less costly to the issuer than more standard variable rate debt. The securities are callable to limit interest rate risk. The

**Higher Education Capital Finance Alternatives**

| Conventional Alternatives | Innovative Alternatives | Ambitious Alternatives |
|---|---|---|
| Consider term and security structures | Address credit standing | Review corporate structure |
| Consider leasing | Review new sources of state assistance | Consider the formation of new financial systems |
| Consider taxable debt | Consider emerging corporate finance concepts (e.g., securitization) | |
| Review credit support alternatives (e.g., reserve fund line of credit) | Consider foreign-denominated debt or overseas issuances | |
| Consider private placement | | |
| Review new capital market developments (e.g.,new pricing and service combinations) | | |
| Review new techniques (e.g., swaps) | | |
| Keep abreast of professional issues | | |

Commonwealth of Massachusetts provides an example of how this concept can be adapted for higher education. The Commonwealth proposes to issue college savings bonds with interest indexed to college costs.

Securitization is another corporate finance concept which may have application in the higher education market. Generally, securitization is the grouping of financial obligations, or receivables, into a collective pool. Investors, instead of buying individual obligations, purchase an interest in the pool, thereby reducing their risk. This approach has created secondary markets for the "securitized" obligations and opened up the broad credit markets as a source of funding. In the areas of consumer debt, auto loans and mortgage finance, for example, securitization has significantly increased access to and reduced the cost of capital.

Institutions of higher education have potential securitization opportunities in their revenue streams, particularly from tuition and room and board monies, but also from annual giving and other predictable cash flows. Securitization requires pooling a large volume of payment obligations to diversify the risk involved. In addition, quality considerations are very important and the underlying obligations generally must have legally homogeneous characteristics, particularly with respect to their term. While the obstacles are challenging, securitization offers prospects for significant financing advantages, especially if colleges and universities become more active in assisting families in financing their college educations.

**If colleges and universities become more active in assisting families in financing their college educations, securitization may be a valuable financing technique.**

**Selectively Consider Foreign-Denominated Debt or Overseas Issuances.** Foreign-denominated debt and overseas issuances of U.S. dollar-denominated debt for public finance market participants have been both highly publicized and ignored at various times. An intensive examination occurred in connection with the passage of the Tax Reform Act of 1986. Certain federal tax developments since 1986, as well as pre-existing market characteristics, have slowed these developments with respect to tax-exempt debt. Today, foreign-denominated debt and overseas issuances of U.S. dollar-denominated debt are primarily taxable financing options. The additional complications of sorting out currency and interest rate issues make entry into this market a long-term endeavor. Moreover, it is not likely to be an option available to institutions without significant name recognition. Even some states may have difficulty entering this segment of the debt market. However, because of the potential for significant interest rate differentials between domestic and foreign markets, as well as the opportunities to diversify interest rate risk, the necessary time and effort may be worthwhile for certain issuers.

## AMBITIOUS ALTERNATIVES

As in most endeavors, including college and university finance, it is possible to concentrate on short-term objectives and, in doing so, fail to consider larger systemic changes. The topics considered in this section involve strategic financial planning. The benefits are likely to be long-term and the activities may require immediate expenditures for planning which may not be recovered for several years. Moreover, these changes may have implications for organizational structure, management and operations, as well as financial effects.

**There are likely to be times when the interactive forces of management, law and economics converge to make modifications in the organizational structure of a college or university desirable and even necessary.**

**Corporate Spinoffs.** To the lay observer, the structuring and restructuring of corporate America can appear to be a confusing circular process of centralization, decentralization, merger, acquisition, divestiture, formation of conglomerates, breaking up of the same, public equity and debt offerings, and leveraged buyouts. The underlying concept, however, is that business enterprises are continuously evolving as they attempt to be more efficient in achieving their objectives. Colleges and universities have different objectives than business enterprises, but they have the same needs to be effective and efficient in fulfilling their higher education mission.

There are likely to be times when the interactive forces of management, law and economics converge to make modifications in the organizational structure of a college or university desirable and even necessary. For example, the commercial development of certain institutional assets such as real estate, mineral rights, timber rights, commercial applications of research activities, or intellectual property rights may impact the non-profit tax-exempt status of a college or university unless such activities are spun off to a separate legal entity, often a

development corporation. Setting up a separate for-profit corporation also can provide opportunities for equity investments by outside parties, providing a non-traditional financing source for the future. Under certain conditions, there also may be tax-exempt financing advantages to creating institutions which are separate from the parent institution within the meaning of the Internal Revenue Code.

The careful reordering of college and university activities can make a substantial contribution to the accomplishment of the institution's long-term objectives. *These restructurings should be explored very carefully, however, as they may not be easily undone.*

**Form Systems.** Hospitals provide interesting precedents for the restructuring of higher education organizations into more efficient systems to consolidate certain corporate and/or financial operations for mutual economic benefits. Hospitals have formed systems based on joint affiliation by religion, sponsorship or geography. Hospitals often implement system financings by creating a joint Master Trust Indenture and issuing debt secured by Master Notes. The Master Notes are debts of each and all of the group members, but within the group it is understood that each individual institution is responsible for the debt service on borrowings from which it benefits. (It is possible to collateralize this agreement.) In some cases, funds are raised initially to retire or restructure the individual debt of group members, but this is not necessarily a requirement for system formation.

The most significant misconception with respect to system formation is that group members will lose their public and/or legal identities. This need not be the case with respect to either dimension. Indeed, financing techniques used in the creation of shared and centralized computer facilities by several colleges and universities, for example, provide evidence of the near invisibility of some cooperative arrangements. Another potential, and rather far-reaching, application of this organizational approach would be the creation of a limited purpose system to utilize tuition and room and board receivables as securitized financing tools. In sum, systems can be formed for as extensive or as minimal operations as are desired by the participants.

**Higher education finance professionals should be proactive leaders within their institutions as they seek out opportunities to improve on current practices as well as being responsive to identified needs.**

## ACTION PLAN

A primary financial goal of an institution of higher education is to maximize the effective and efficient use of the institution's fiscal, physical and human resources. Ideally, higher education finance professionals should be proactive leaders within their institutions as they seek out opportunities to improve on current practices as well as to respond to identified needs.

The comprehensive nature of this objective requires that it be approached by a financing team which, collectively, can analyze ideas from financial, legal and organizational perspectives. As this core group assesses the institution's needs and develops a business plan with specific financing considerations, specialized experts can be retained as needed to implement the particular financing technique.

The process of inquiry is as important to the college and university business officer as it is to the faculty and the student body. As a business plan is developed, focus attention on the breadth of financing options available to your institution. By analyzing the financing choices inherent in the structure, financial systems and cash flows of your institution, pragmatic and prudent new ideas will be generated to lead and shape higher education capital finance in the future.

### Potential Authors

**Capital Ideas** is distributed without charge to presidents, chief financial officers, chairmen of the trustee finance committees, as well as a number of higher education officials and policy makers. All previous issues of were written by Forum staff. This is the first issue for which there has been a guest author and we expect to continue the practice in the future. **If you have material which you think would interest our readers, please contact us at the following address**: Dr. Richard E. Anderson, Box 34, Teachers College, Columbia University, NY, NY 10027.

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